
Treating the symptom not the condition: Crisis definition, deficit reduction and the search for a new British growth model

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Abstract: It has taken quite a while for a consolidated crisis discourse to emerge in Britain in response to the seismic events of 2007-09. But one is now clearly evident, widely accepted and deeply implicated in government economic policy. It is a ‘crisis of debt’ discourse to which the response is austerity and deficit reduction; it is paradigm-reinforcing rather than paradigm-threatening. In this paper I consider the appropriateness of such a crisis discourse, arguing that an alternative ‘crisis of growth’ discourse is rather more compelling and would point in very different policy directions whilst generating very different expectations about the effects of deficit reduction. Such a discourse can just about be detected in the growing criticism of the government’s austerity programme, but it is yet to lead to the positing of a new growth model. I explore the implications of both crisis discourses for responses to the crisis, concluding with an assessment of the prospects for the return to growth under a new growth model in the years ahead.

The politics of blame attribution: mistaking a crisis of growth for a debt crisis

As the literature on crisis has established well, the politics of blame attribution are crucial to shaping the kind of policy responses we make to seismic events (see for instance Hay 1999). Crises are, in effect, what we make of them; and what we make of them determines how we respond. This is as true of the present crisis as it is of more obviously path-shaping moments of political and institutional change. Thus, for as long our current crisis prompted little more than the latest bout of banker bashing (the berating of ‘Scumbag Millionaires’ in *The Sun’s* memorably headline) and

culpability remained correspondingly individuated, we were always unlikely to see concerted action to address the underlying pathologies the crisis exposed. Yet we have undoubtedly moved on from this. A crisis discourse is now firmly established and it has a strong hold over government policy; but that crisis discourse is paradigm-reinforcing rather than paradigm-threatening. However obvious that might seem, it is a crucial point and one that bears repetition. For it is not something for which the existing literature, in its typical (and perhaps understandable) concern to link crises with episodes of paradigm succession, does not prepare us well (Blyth 2002; Hall 1993; Pemberton 2009).

The crisis discourse that has consolidated in Britain since the election is one of *a crisis of debt* – to which, of course, austerity and deficit reduction is the solution. And that, in itself, is interesting. For this is, in effect, a second-order crisis discourse – in that it would seem to posit a primary or originating crisis (typically referred to simply as the ‘global financial crisis’), the domestic effect of whose (mis)management has been to generate the present crisis of debt which now needs to be addressed. As this suggests, seen in such terms the debt crisis is itself a symptom of the originating (and presumably more fundamental) crisis out of which it arose; and deficit reduction is revealed as a form of symptom amelioration rather than crisis resolution. We will return in rather more detail to the implications of this presently. But suffice it for now to note that were the crisis constituted differently, as a (first order) *crisis of growth* not a (second order) *crisis of debt*, then austerity and deficit reduction would be no solution at all. Indeed, they would almost certainly be seen likely to be compound the problem. No less significantly, were the crisis accepted as a crisis of growth, a paradigm shift might be rather more imminent. Crisis discourses, as this suggests, are no more politically innocent today than they were in, say, the late 1970s. Unremarkably, whether a crisis proves paradigm-challenging or paradigm-reinforcing depends on how it is perceived – specifically whether it is seen to signal an exhaustion of the paradigm or (as here) to emerge from a violation of its core precepts.

Yet we need to be careful here. For the current debt crisis discourse – though firmly established in Britain – has not gone unchallenged; and that challenge, though to some extent still implicit, is growing in intensity. To be clear, this is certainly not as yet the pitting of competing crisis narratives against one another. But, under the leadership of

Ed Miliband, Labour has begun to counterposes a ‘Tory cuts’ discourse to the Coalition’s ‘Labour’s debt’ discourse. The former might be taken to imply (for reasons we will examine in more detail presently) an understanding of the crisis as one of growth rather than debt. Yet, thus far at any rate, that alternative crisis discourse has not been articulated publicly and it has certainly not led to the positing of an alternative growth strategy – the corollary of such an alternative. But the point is that it could ... and might still.

What makes this more likely is that we are now entering a period where the effects of deficit reduction are starting to bite after an extended period in which they have been promised yet largely deferred. And we do so at a time when there is an almost palpable sense that the public is starting to tire of the blame attribution part of the coalition’s broader debt crisis discourse – with, for instance, the recent booing of members of the coalition government on *Question Time* each time they have repeated the well-worn mantra that the debt to which they are responding is the product of Labour profligacy in office (this began with Francis Maude in Bristol on 10/2/11).

Yet the booing of Francis Maude by a *Question Time* audience in Bristol is one thing; the public’s wholesale rejection of the Coalition’s blame attribution strategy for the deficit is another thing altogether. Moreover, it is clearly possible to reject the suggestion that the deficit is to any significant extent a simple product of Labour’s profligacy in office whilst retaining the notion of this as a crisis of debt. The former is evidently (and evidentially) wrong (see Dolphin 2011); the latter is at least a matter of interpretation (there is, after all, a substantial deficit). But the point is that such blame attribution is a key part of the Coalition’s debt crisis discourse – and, it seems, it is the part of that discourse which most lacks public credibility.

The question of Labour’s culpability: falling out of love with prudence?

This brings us to a key theme of the emerging literature on the crisis – the question of (New) Labour’s culpability in and for the crisis (for contrasting views of which, see Coates 2009; Pemberton 2009; Thain 2009). This is a tricky issue. For, in the end, what matters politically is not whether and to what extent we, *but the electorate*, held, hold and continue to hold Labour in office culpable. Whether it *deserves* to be held

culpable is a secondary and a more narrowly academic consideration. Consider first public attributions of culpability. Surprisingly, perhaps, and despite presiding over the onset, at least, of the longest and deepest recession Britain has endured since the 1930s, Labour has avoided much of the blame (the contrast with the experience of Fianna Fail in Ireland is surely telling). It did far better at the polls in 2010 than, in a sense, it had any right to do. Thus, even if the electorate had by this time become convinced of the need for deficit reduction (on which, of course, there was cross-party consensus) it seemed reluctant to assign responsibility for carrying this out to the opposition. The Conservatives, it appears, were deemed just a little too enthusiastic to be entrusted with what was clearly seen as the *unfortunate* necessity of deficit reduction. Moreover, as we have seen more recently, significant portions of the electorate are also deeply sceptical of the claim that the deficit is a product of Labour's fiscal imprudence – the reflection of an ideological commitment to public expenditure growth at the expense of sound economic management.

If this is right, then Labour would appear to have been quite fortunate, certainly when compared with the ostensibly analogous administration of Jim Callaghan or, indeed, its immediate Irish counterpart. To what might we attribute this comparative good fortune? Perhaps two things. First, certainly in contrast to such comparators, Labour had a good crisis. Brown, in particular, got most things right – and, perhaps more significantly, he was *seen* to get most things right, certainly internationally (see, for instance, Krugman (2008: 185). In a manner that clearly belied his hardly enviable domestic reputation at the time, he was – and was seen to be – both decisive and influential internationally. He led, in effect, a surprisingly coordinated if short-lived proto-Keynesian counter-offensive to the crisis. Second, and no less significant, was the absence of a clearly articulated political alternative. However vociferous their general criticism of the government and its handling of the crisis, it was never made clear during the 2010 General Election what (if anything) the Conservatives would have done differently had they been in office. Moreover, with all the parties committing themselves during the campaign both to deficit reduction and to a broadly similar time-frame for its delivery after the election, the economic stakes of the contest appeared at the time surprisingly low. Lacking a clear sense of what had gone wrong, how the Conservatives might put it right, and what kind of change in economic policy trajectory this might entail, the Conservatives were not well placed

to exploit and reinforce any loss in Labour's perceived economic competence and credibility. The crisis has, then, proved far less economically discrediting for Labour than one might well have anticipated; if one is in any doubt, one need only consider the position of Fianna Fail today.

But if Labour was fortunate, in effect, in the opposition it faced, then did it deserve such good fortune? To what extent *should* it have been held more culpable for the crisis? That, as already indicated, is a difficult question to answer definitively and there is arguably little to be gained by dwelling on it at any length here. But a number of points can perhaps be made.

First, there is clearly plenty of culpability to go around. If any part of the broader analysis of the British case on which I draw is correct (see, for instance, Hay 2010, 2011a, 2011b; Hay and Wincott 2011; Watson 2010), then the British growth model was peculiarly exposed to this kind of a crisis in a manner that was not at all difficult to anticipate (indeed, see Hay 2006). At minimum, then, the New Labour administrations of both Blair and Brown were culpable, along with the Monetary Policy Committee of the Bank of England, for their failure to appreciate and mitigate the fragility of the growth model they were nurturing and for their failure to anticipate a crisis that was eminently predictable (at least in outline form). Yet, what is also clear is that the largely private debt-financed growth model that expired with the crisis predated New Labour's tenure in office. What makes the question of culpability altogether more difficult to answer is that what we might now describe as its growth model remained unacknowledged for some time after New Labour came to power – in effect the government remained largely unaware of the role of easy credit, private debt and asset-price appreciation in the generation of the growth for which it was taking credit. The growth model was much more the product of serendipity than of conscious design. That must surely temper Labour's culpability to some extent; it would, after all, seem harsh to hold it culpable for things of which it was unaware. But this 'innocence through ignorance' defence is time-delimited. From around 2000 onwards it was clear, not least through its open advocacy of an 'asset-based' model of welfare, that New Labour was both acutely conscious of, and keen to nurture, what Colin Crouch usefully terms a 'privatised Keynesian' growth model (2008; see also

Watson 2010). The inherent fragility of that model neither it nor its MPC allies seem to have considered. For this both must surely bear some significant responsibility.

Getting what went wrong right ... and putting it right

But this is to dwell, in a perhaps overly mawkish way, on the past – on the (endogenous) *origins* of the crisis.¹ That is the easy bit. Altogether more difficult, and altogether more pressing, is to reflect on how alternative understandings of where we are now and how we have got here might lead to rather different *responses* to what ails us as we go forward.

Here it is useful to return to the most obvious current conflict between the Coalition and the opposition on economic policy. This pits, as we have seen, the ‘Labour’s deficit’ and ‘Tories’ cuts’ discourse against one another. As we have also already seen, much of this discursive battleground concerns the attribution of political responsibility for our afflictions. It is about blaming others for our past, present and future ills. But as narratives, these competing accounts rest on rather different – and in fact deeply antithetical – assumptions about the crisis itself and hence the nature of those afflictions. It is useful to tease these out; for it shows that the stakes of inter-party competition have grown significantly since the election.

Thus, and whether or not this was the case during the campaign, Labour certainly now seems to understand the crisis differently to the Conservatives – in ways that are clearly crucial to how we should respond to it. That may not be terribly surprising, but it is extremely important, as we begin to see if we start to tease out the implicit alternative understanding of the crisis on which its ‘Tories’ cuts’ discursive offensive is predicated.

There are at least three implicit premises to Labour’s ‘Tories’ cuts’ discourses: (i) that cuts, at least on this scale and at this pace, are unnecessary and hence a political choice rather than an economic imperative; (ii) that things would be different were

¹ And there are, of course, exogenous origins too (for detailed account of which from the same perspective see Hay 2011a; Hay and Wincott 2011).

Labour exercising that political choice; and (iii) that cuts, or at least cuts on this scale and to this time-frame, are not only unnecessary but themselves damaging. A final and more narrowly political premise is that the deficit reduction agenda is in fact a foil for a Tory (rather than coalition) ideological offensive on the public sector. In the present context, however, it is the third of these premises – that deficit reduction on this scale is itself economically damaging – that is by far the most important. Yet there remains much ambiguity about this in Labour's discourse, not least because the party remains ostensibly committed to a halving of Britain's deficit in a single parliamentary term. That is, of course, difficult to reconcile with the idea that the Coalition's programme of public spending cuts – which may, in the end, very well struggle to deliver a halving of the deficit by 2015 – is economically damaging. But at times it has been possible to detect in Labour's thinking more of a Keynesian influence – with growth rather than deficit reduction becoming the focus and with deficit reduction being seen less as the primary goal of policy than as a happy bi-product of policies to nurture growth. Only time will tell if this crystallises into a more obviously Keynesian alternative crisis discourse; but there is some potential for it to do so, especially once the effects of public spending cuts start to become evident.

The point is that, were it to do so, we would have two very different understandings of the crisis with very different implications for the appropriate policy set to respond to it and very different expectations of the consequences of the Coalition's current programme of deficit reduction.

Such an alternative crisis discourse might build from the fiscal origins of Britain's current predicament, noting that had taxation revenues continued to grow at pre-crisis levels, they would have exceeded the actual tax take by around £35 billion in 2008-09 and £92 billion in 2009-10. Put slightly differently, approximately 70 per cent of the current account deficit in 2008-09 and 86 per cent in 2009-10 can be attributed to lost taxation revenue associated with falling economic output (Hay and Wincott 2011). From such a perspective, it would be alarming indeed to commit to reducing the deficit at a time of static or negative growth. If the problem is seen as arising from a lack of growth, then self-imposed further deep cuts in economic output in order to rebalance the public finances in record time seem both unnecessary and counter-productive – especially in an economy whose growth has been so closely allied to

consumer demand in recent years. Indeed, from such a perspective, deficit reduction becomes a tacit acceptance of and capitulation to the idea of Britain as a smaller economy – an economy which can and will no longer be able to afford the public sector to which it had previously become accustomed.

As this suggests, if the crisis is seen as a crisis of growth (of which debt is merely a symptom) rather than a crisis of debt per se, then the dangers of deficit reduction as a putative solution become very obvious. No less significantly, this leads to very different expectations about what may now come to pass. Indeed, the more Keynesian ‘crisis of growth’ theory and the more orthodox ‘crisis of debt’ theory generate wildly divergent expectations about levels of growth in the months and quarters ahead.

As this perhaps suggests, had the Labour opposition the courage of its seemingly more Keynesian convictions it might even challenge the Coalition to a contest over economic predictions. The irony here is that the Coalition’s actions in office have only served to make such a hypothetical test more definitive. For, as the NIESR pointed out at the time, the 2010 Emergency Budget’s revised timetable for fiscal rebalancing in fact *delayed* already planned spending cuts (Weale 2010). Moreover, the more detailed programme of deficit reduction subsequently set out in the Comprehensive Spending Review is presently running at least a full quarter behind schedule. Consequently, we have witnessed a relatively prolonged period of classic deficit financing that is now (eventually) giving way to a classic bout of austerity and deficit-reduction – writing in the June 2011 we are now, in effect, at the point of inflection on the graph. Keynesians would anticipate from here the slide into a double-dip recession; the government and its allies in the OBR and the Bank of England are on record publicly as anticipating steadily accelerating growth.

It would not be difficult to put such divergent expectations to the test publicly. “Let’s see who has the better understanding of the economy”, Labour might taunt. In such a context and following such a contest, if rapid deficit reduction did indeed produce negative growth, then it would be far easier to discredit both the policy and the economic theory on which it was predicated. And what would make such a battle of expectations even more difficult for the government is the systematic bias in its

growth projections to date. As Alan Budd conceded shortly before leaving the OBR, its own growth projections have consistently erred on the side of optimism – for fear that too much realism might spook the markets. Suffice it to note that the Treasury, the MPC and the OBR have spent considerably more time revising downwards their growth projections in recent months than they have revising them upwards. At minimum, then, a public contest over economic expectations might lead to a rather greater dose of economic realism.

This begins to look like something of an alternative economic strategy for Labour.² But as a strategy, it lacks one key thing. For what such an alternative crisis discourse calls for is a new growth model to replace the one that is broken. And herein lies the problem. For although, in their different ways, all of the principal parties acknowledge the need for an alternative growth model, none appear to have a clear sense of what one might look like. It is certainly tempting to suggest that what Britain needs is a heavy dose of Keynesianism – or at least a government with the courage of Keynesian convictions. Such an administration might warn of the dangers of compounding Britain's problems with swinging public sector spending cuts in the absence of a clearly articulated growth strategy, set out precisely such a growth strategy, and link deficit reduction clearly and explicitly to the growth such a strategy might produce, pre-committing itself to different levels of deficit reduction depending on the growth rate attained. But this in itself is not sufficient. For, in the absence of an alternative growth model, it still falls far short of the minimum required to animate an alternative economic strategy.

It is, of course, not too difficult to imagine what an alternative growth strategy for the British economy might look like - with, for instance, the channelling of credit out of the housing market and into what are identified as strategically significant (and export-oriented) sectors of the economy. But there has, to date, been virtually no public discussion of the options available, there would seem to be remarkably little academic or other preparatory work to draw on in the British context in developing such a strategy and, whilst the growth dividends from such a strategy might be

² The analogy with Labour's 1983 manifesto – another 'alternative economic strategy' - is unintended and not especially helpful.

considerable they are unlikely to come on stream in the short-term. Genuine comparative advantages are not easily or rapidly acquired, especially in a world economy only slowly recovering from recession.

The search for growth

It is invariably at precisely this point that analyses such as I have presented thus far break off. But that will not do. In what follows I try to address the question of growth and the impediments to growth as directly as possible – albeit in a necessarily preliminary way. I would urge others to do likewise and, indeed, to engage with the following analysis and policy recommendations.

I begin with the impediments to growth with which any new growth model or strategy would have to contend.

The first of these relates to monetary policy and to the link between inflation and interest rates. As is now widely appreciated, the dependence of the old ‘privatised Keynesian’ growth model on private debt typically secured against a rising property market increased the sensitivity of demand in the economy to interest rate movements and, in the process, the threat to growth posed by inflationary pressures (or, at least, inflationary pressures giving rise to interest rates hikes). That problem, though temporarily suspended during the crisis itself, is now threatening to return with a vengeance, as figure 1 strongly suggests.

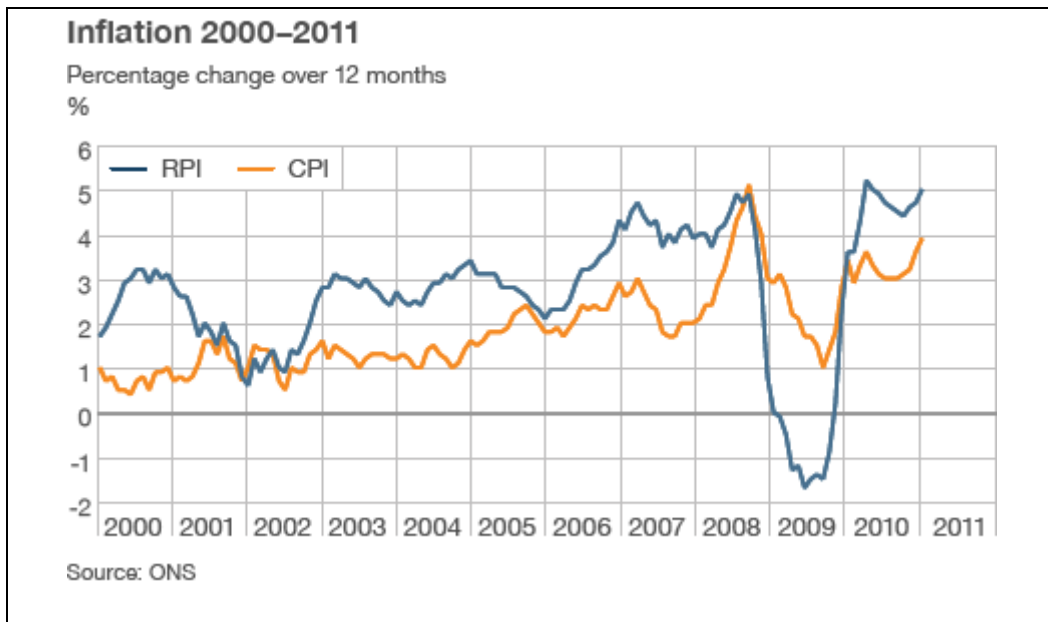


Figure 1: The problem of inflation management in Britain today

What is perhaps most alarming about this graph is the resumption of the pronounced and steady upward trend in both the CPI and RPI in the period since the crisis. Like that in the period before the crisis, this has been driven to a large extent by oil price fundamentals reinforced by speculative dynamics (see, for instance, Davidson 2009; Kaufmann and Ullman 2009; Sornette Widward & Zhan 2009). In the final quarter of 2010 it saw a return to the condition of stagflation that the economy experienced from late 2007 until the collapse in oil prices prompted by the US recession. What is interesting about this is that last time this arose, the Bank of England was incapable of controlling inflation without the housing market crashing – and its increasingly accommodating monetary stance since early 2010 would appear to indicate that it is no more confident of being able to do so today. It need hardly be pointed out that the housing market is a much more fragile thing today than it was in 2007. We may well be teetering on the brink of the precipice once again.

This has made the resumption of geopolitical instability in the Gulf states, however much one might welcome the reasons for it, all the more alarming economically. Brent crude is now above the much-feared and much-vaunted \$120 per barrel figure typically seen as the point beyond which global economic output might start to falter. The implications of any such global downturn for Britain would in all likelihood prove particularly severe, coinciding as well they might with a wave of public sector

redundancies and almost certainly resulting in a run on sterling – exacerbating the inflationary pressures associated with appreciating oil prices (denominated in dollars). It was this kind of combination of factors (absent of course, public austerity and a decline in world economic output) that precipitated the bursting of Britain’s housing bubble in the first place. Arguably many of those conditions are present once again.

This is compounded by a second factor. If one were to look at the mounting inflation problem simply in terms of the Base Rate, one might be forgiven for thinking that the problem was not that profound – after all, the Base Rate is still at a historically unprecedented 0.5 per cent. Surely, then, there is plenty of scope for increasing interest rates to cope with imported inflation? Perhaps, but the point is that the Base Rate is not quite what it once was; indeed, it’s not quite what it was even very recently. It was widely noted at the time that, as the crisis unfolded the LIBOR spread (essentially, the difference between the inter-bank lending rate and the Base Rate) grew significantly and has since closed up again. What is rather less commented upon is that the equivalent mortgage and commercial lending rate spreads which also widened considerably during the crisis have yet to close up again (though see King 2011 for a very recent admission of this as a problem).

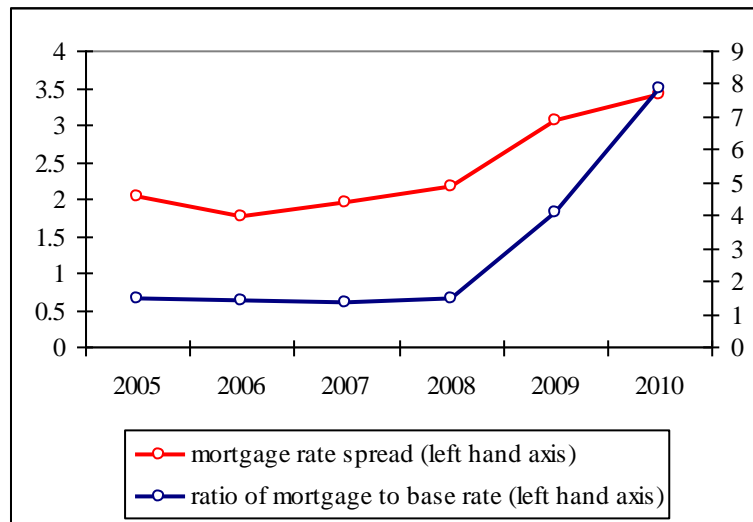


Figure 2: Britain’s step-level increase in the cost of borrowing
 Source: calculated from HM Treasury pocket book data series (2011)

This is clearly demonstrated, for mortgage lending, in figure 2 - which shows both the mortgage spread and the ratio of average mortgage lending rates to the Base Rate since 2005. It reveals, in effect, a step-level increase in the cost of borrowing in Britain that has too often gone unnoticed. A first time-buyer seeking, say, an 80 to 90 per cent mortgage will typically be offered a fixed interest lending rate of around 6 per cent – an historically unprecedented multiple of 12 times the Base Rate. The growth in the mortgage rate spread that the graph indicates is a tacit form of bank recapitalisation – and it is also a significant drain on consumer demand and hence growth.

In practice, then, the effective Base Rate is far higher than 0.5 per cent - and, as is now clear, even at this rather higher effective level inflation remains unchecked. What is more, with such large mortgage and commercial lending rate spreads, the Base Rate becomes a less effective instrument of monetary policy, since the relationship between the Base Rate and actual lending rates is more mediated than before. Whilst the banking sector recapitalises, the government and MPC would seem to have turned a blind eye to this; but it is arguably a much more significant issue than the scale of investment bank bonuses which have attracted far more political scrutiny.³ For, so long as commercial and mortgage lending rates remain punitive (at least relative to the Base Rate), investment is being crowded out, in effect, by bank recapitalisation – making both the partial resuscitation of the old growth model and the transition to a new one (based to some extent on a revived manufacturing base) less likely. It is, then, a serious impediment to growth.

In this context, the Bank of England's conduct of monetary policy warrants further scrutiny. What any such scrutiny reveals is that the politicisation of monetary policy that occurred in the run-up to the crisis continues today. As I have argued elsewhere (Hay 2009), in the second half of 2007 despite accelerating inflation, the Bank of

³ This is, in effect, an argument for politicising the cost of commercial and consumer borrowing, not for depoliticising bank bonuses – indeed, the two are intimately connected. Part of that politicisation process might well involve shaming the banks (certainly those in receipt of public funds) into acknowledging their public duty not to provide bonuses to their investment bankers until such time as they have no need to recapitalise their investment arms through cross-subsidies arising from commercial and consumer lending. I am grateful to Andrew Baker for pushing me to clarify this point.

England halted and then reversed the sharp upward movement in the Base Rate that its mandate dictated. In effect, it ceased trying to control consumer price inflation and sought instead to support the housing market which was already on the verge of free-fall from the consequences of its own mandate. The Bank, it seems, unlike its ECB counterpart, came to share in the government's disaggregated view of inflationary pressures – 'consumer price inflation bad, house price inflation good'.

That it is doing so again makes something of a mockery of its public mandate – and, with it, the basis of the claim that it is independent of political influence. Indeed, judging by its actions (and its published rationale for monetary policy settings in recent months), the Bank appears to have rewritten its mandate – targeting not current inflation per se but a rather optimistic sense of what inflation is likely to be in two years' time, especially where that optimism allows a more accommodating stance such as might help sustain house prices and consumer demand.

It is, of course, not inappropriate that the MPC should consider the implications of its interest rate settings for growth. But what is interesting is that, judging by its conduct, it is still seeking to revive the old growth model – in that its actions would seem more consistent with holding up the housing market than with controlling inflation. There is a certain irony about this too, since RPI (which includes the cost of mortgage repayments) is already higher than the CPI due not to house price inflation but to the rising costs of servicing mortgage payments despite the unprecedentedly low Base Rate. In effect, the tolerance of a greater mortgage interest rate spread has weakened the Bank's ability to resuscitate the housing market using monetary policy, leading it to adopt a far more accommodating monetary policy stance than it might otherwise have done and compromising, in the process, its ability to control inflation.

It was never going to be easy to resuscitate the old growth model – and there are undoubtedly limits to the growth that any such revivification is likely to generate. Indeed, the long-standing problem here is intergenerational and would ultimately have compromised the old growth model at some point anyway. For, in the end, sustained house price inflation at 10 per cent per annum over a number of decades (as Britain has seen since the 1960s) was always going to create a crisis of affordability for new entrants into the housing market at some point – cutting off at source the demand that

has fuelled rising house prices in the first place. That point has been brought forward, dramatically, by the crisis - and the intergenerational problem of affordability is now being compounded by a step level increase in the cost of mortgage lending over the Base Rate and the increased levels of personal debt that will follow the withdrawal of state funding for higher education. Even in the absence of a swinging programme of public austerity, it is difficult to see how 'privatised Keynesianism' might provide again the basis for sustained economic growth – for it was not ultimately sustainable in the long term even in the absence of the crisis. But that would appear to be precisely what the MPC is banking on.

Conclusion: towards a new British growth model

Again, it seems, all paths lead to an inevitable conclusion – the need for an alternative growth model. But even assuming one could be found, there are significant problems.

The first of these arises directly from of the preceding analysis. A long-standing pathology of British capitalism has been the cost of capital – and it re-emerges again as a problem today at a time when the transition to any new growth model is likely to require significant levels of investment. It might seem counter-intuitive to point here to the *cost* rather than the *supply* of capital – after all, the Base Rate is as low today as it has ever been. Yet, despite this, the terms under which capital is supplied are far from favourable – with very similar interest rate spreads to those we have seen open up in mortgage lending. Credit is essentially still being rationed through punitive interest rates and this is crowding out investment.

The problem is reinforced by a further factor – the drop in the value of the commercial property against which many commercial credit lines are secured. Taken together, these factors make it very difficult to envisage the transition to an alternative, say export-led, growth strategy built on the back of private investment – and the parlous condition of the public finances would seem to preclude a programme of public investment to effect a similar transition. As a Bank of England *Financial Stability Report* noted late in 2009, “falls in commercial property prices have raised average loan to value ratios above 100 per cent according to industry estimates” (Bank of England 2009: 7). The economy’s capacity to raise capital to build a new

export-led growth strategy capable of capturing new markets would seem rather limited; and the withdrawal of significant amounts of state support for human capital formation merely compounds matters.

A couple of policy implications follow fairly directly from this. First, if the economy is to be ‘rebalanced’ (a term used by all of the principal parties when they talk of growth), then the government and the Bank of England need to be putting concerted (if selective) downward pressure on the actual cost of borrowing (independent of the Base Rate) in sectors where a clear link to the growth strategy for the economy can be made and substantiated. If, for instance, that growth strategy is to involve a targeting of export-led growth in manufacturing, then commercial lending rates here need to be falling (even if the Base Rate is rising).

Second, difficult though it is to make the case at a time when there appears to be a cross-party consensus on the need for deficit reduction, there is a strong argument to be made for public investment in support of a clearly articulated growth strategy built on identifying and supporting growth in a series of key export-oriented sectors. Apart from anything else, and for some of the reasons detailed above, the cost of financing long-term public borrowing is significantly lower than for commercial lenders. Moreover, public infrastructure projects are likely to be key to any reconfiguration of the economy which might more closely align its structure to a new (and more clearly export-oriented) growth strategy. Public investment may, in other words, be a highly cost effective way of providing the public goods on which the transition to a new model of growth relies.

One way of achieving this may be to consider issuing public debt in the form of hypothecated investment/growth bonds. These would deliver a marginally higher rate of return to investors than general government debt (as an incentive to purchase them and in reflection of their anticipated contribution to investment-led growth). The debt secured in this way would be used to resource a targeted growth strategy – by, for instance, subsidising the cost of borrowing in sectors seen as strategically significant in a rebalancing of the economy. Such bonds would provide a form of ethical public investment. In addition to such growth bonds, hypothecated NHS and other public infrastructure investment bonds might also be considered on a similar model (for an

earlier attempt to explore the possibilities of using hypothecated investment vehicles to compensate for low levels of productive investment in the UK economy and to make the transition to a new model of growth, see Watson and Hay 1998).

Yet this is no panacea. For the task of rebalancing the economy is an immensely difficult one, however urgent. Take, for instance, manufacturing – typically placed at the heart of calls for an alternative growth strategy and much vaunted as such in both the Labour and Conservative manifestos in 2010. Commentators have invariably drawn some comfort from recent data which show reasonably strong growth in manufacturing output and an associated modest improvement in the balance of trade figures. Yet such data arguably flatter the strength of Britain's manufacturing sector and they certainly give no sense at all of the difficulties of reorienting the economy around a new export-led growth strategy in which manufacturing might play a key role.

A number of points might be made here. First, the overall improvement in the balance of trade figures is slight and very recent. Since the onset of the crisis and despite the devaluation of sterling in most of its key export markets, Britain's substantial balance of trade deficit has in fact widened. Second, the recent reduction in the deficit arguably owes less to manufacturing growth than it does to low levels of domestic demand relative to demand in key export markets. Third, and perhaps most importantly, such growth in manufacturing output as there has been has occurred at a time when existing capacity is not being fully utilised. The real test of a manufacturing-led reorientation of the growth strategy only comes at the point at which existing capacity needs to be augmented (through investment) to sustain growth – and it is at precisely this point that the cost of capital is likely to prove decisive.

That is not all. For even were such capacity constraints to be overcome and the manufacturing sector to grow at a most unlikely 10 per cent per annum for the next 5 years, we would be talking of a growth of employment of no more than one million (even on the most optimistic of assumptions). The contribution to annual GDP growth would be between 1.5 and 2 per cent (rising with the relative size of the manufacturing sector in the overall economy) - a relatively modest figure given the emphasis so often placed on manufacturing in alternative accounts of growth. As this

suggests, such a ‘rebalancing’ is not in itself a growth strategy; though it might well be a significant element of one.

There are clear policy implications of this too – though, again, they may not be altogether palatable to those who would like to put their faith in a simple transition to a finance- and related services-light and manufacturing-dense export-oriented growth strategy (a sort of British *Modell Deutschland*). They are essentially three-fold.

First, however important the manufacturing sector is likely to prove in a reorientation of the British economy capable of generating sustained and sustainable economic growth, it would be naïve in the extreme to see it as a potential fount of British growth in the decades ahead. It is no panacea. Moreover, the reorientation of the British economy around manufacturing is, at best, a long-term strategy – which may well yield significant dividends over two or more decades but which is most unlikely to contribute significantly to British growth in the short to medium-term.

Second, this almost certainly means that the British economy needs, in the interim at least, to make do with a growth strategy that looks rather more like the old one than might seem ideal – whilst preparing the groundwork and making the transition to another. That, of course, has major policy implications – not least with respect to monetary policy and the regulation of the banking sector. In terms of the former, it suggests that the Bank of England’s currently highly accommodating monetary policy stance is right, but perhaps too limited in its ambition. Consumer demand sustained by personal debt played a crucial role – arguably too crucial a role – in the generation of growth in the British economy throughout the great moderation; and, whether we like it or not, it will have a crucial role to play in any resuscitation of growth in the years ahead. But what the British economy needs is a far more selective and strategic channelling of the supply of credit – out of the housing market (whose growth was, in the long-term, unsustainable anyway) and into new sources of growth (in manufacturing and services). That entails not just an accommodating monetary stance, but a focussed assault on interest rate spreads in areas identified as targets for investment in the new growth model.

Finally, the above analysis has intriguing and perhaps surprising implications for the regulation of the banking sector. It suggests that, from the British perspective at least, the current focus on investment banking and the bonuses of investment bankers is misplaced and may in fact be something of a distraction. For now at least the British economy cannot do without the contribution to economic output arising from financial services. Here it is important to note (however unpalatable it might seem) that the immediate predicament of the British economy would be far worse had the global financial reregulation advocated by many reduced the volume of short-term trading in the world economy (through some form of taxation on speculative transactions). Yet the implication of this is not that British policy-makers should ease up on investment banking, whilst refocusing their attentions of commercial banking. Rather, it is that they need to reconsider the relationship between the two. For, as I have been at pains to demonstrate, a major impediment both to the resumption of growth and to the kind of investment levels that will be required to make the gradual transition to a new growth model is the crowding out of potential investment by the punitive interest rate premiums currently demanded by commercial lenders – and such punitive interest rates are themselves a product of the covert recapitalisation of investment banking. In short, commercial banking is subsidising investment banking in a way that impairs the capacity to build a new growth model. As this suggests, a refocusing of the public assault on the banking sector is long overdue.

Taken together these observations suggest once again the difficulty of the task that British policy-makers face in the years ahead. Britain has lost a growth model as, in their different ways, all the principal parties now accept. But it has not found an alternative; and the transition to an alternative – if, as and when one can be identified – is unlikely to prove a rapid or painless process. It really is *that* bad; and it is likely to get worse before it gets better.

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